



**8011-01p**  
**SECURITIES AND EXCHANGE COMMISSION**  
**(Release No. 34-68453; File No. PCAOB-2012-01)**

December 17, 2012

**Public Company Accounting Oversight Board; Order Granting Approval of Proposed Rules on Auditing Standard No. 16, Communications with Audit Committees, and Related and Transitional Amendments to PCAOB Standards**

**I. Introduction**

On August 28, 2012, the Public Company Accounting Oversight Board (the “Board” or the “PCAOB”) filed with the Securities and Exchange Commission (the “Commission”), pursuant to Section 107(b)<sup>1</sup> of the Sarbanes-Oxley Act of 2002 (the “Sarbanes-Oxley Act”) and Section 19(b)<sup>2</sup> of the Securities Exchange Act of 1934 (the “Exchange Act”), proposed rules to adopt PCAOB Auditing Standard No. 16, “Communications with Audit Committees,” and related and transitional amendments to PCAOB standards (collectively, the “Proposed Rules”). The Proposed Rules were published for comment in the Federal Register on September 17, 2012.<sup>3</sup> At the time the notice was issued, the Commission designated a longer period to act on the Proposed Rules, until December 17, 2012.<sup>4</sup> The Commission received five comment letters in response to the notice.<sup>5</sup> On November 9, 2012, the PCAOB submitted a letter addressing certain comments received by the Commission.<sup>6</sup> This order approves the Proposed Rules.

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<sup>1</sup> 15 U.S.C. 7217(b).

<sup>2</sup> 15 U.S.C. 78s(b).

<sup>3</sup> See Release No. 34-67804 (September 10, 2012), 77 FR 57408 (September 17, 2012).

<sup>4</sup> Ibid.

<sup>5</sup> See letters to the Commission from Howard B. Levy, Principal and Director, Technical Services, Piercy Bowler Taylor & Kern, dated September 28, 2012 (“Piercy Letter”); Robert L. Leclerc, Chairman, Quest Rare Minerals

## **II. Description of the Proposed Rules**

Auditing Standard No. 16 will supersede PCAOB interim auditing standard AU section 380, “Communication with Audit Committees” (“AU sec. 380”), and interim auditing standard AU section 310, “Appointment of the Independent Auditor” (“AU sec. 310”). Auditing Standard No. 16 retains or enhances existing audit committee communication requirements, incorporates SEC auditor communication requirements set forth in Rule 2-07 of Regulation S-X,<sup>7</sup> provides a definition of the term ‘audit committee’ for issuers and non-issuers, and adds new communication requirements that are generally linked to performance requirements set forth in other PCAOB auditing standards.

Auditing Standard No. 16 requires the auditor to establish an understanding of the terms of the audit engagement with the audit committee. This requirement aligns the auditing standard with the provision of the Exchange Act, as amended by the Sarbanes-Oxley Act, that requires the audit committee of listed companies to be responsible for the appointment of the external auditor.<sup>8</sup> Additionally, Auditing Standard No. 16 requires the auditor to record the terms of the engagement in an engagement letter and to have the engagement letter executed by the appropriate party or parties on behalf of the company and determine that the audit committee has acknowledged and agreed to the terms.

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Ltd., dated September 30, 2012 (“Quest Letter”); Tom Quaadman, Vice President, Center for Capital Markets Competitiveness, U.S. Chamber of Commerce, dated October 5, 2012 (“Chamber Letter”); Deloitte & Touche LLP, dated October 5, 2012 (“Deloitte Letter”); and Cindy M. Fornelli, Executive Director of the Center for Audit Quality, dated October 9, 2012 (“CAQ Letter”).

<sup>6</sup> See letter to the Commission from the PCAOB, dated November 9, 2012.

<sup>7</sup> 17 CFR 210.2-07.

<sup>8</sup> See Section 10A(m) of the Exchange Act, as added by Section 301 of the Sarbanes-Oxley Act.

Auditing Standard No. 16 requires the communications with the audit committee to occur before the issuance of the audit report. The standard requires auditors to communicate, among other matters, the following to audit committees:

- Certain matters regarding the company's accounting policies, practices, and estimates (consistent with Rule 2-07 of Regulation S-X);
- The auditor's evaluation of the quality of the company's financial reporting;
- Information related to significant unusual transactions, including the business rationale for such transactions;
- An overview of the overall audit strategy, including timing of the audit, significant risks the auditor identified, and significant changes to the planned audit strategy or identified risks;
- Information about the nature and extent of specialized skill or knowledge needed in the audit, the extent of the planned use of internal auditors, company personnel or other third parties, and other independent public accounting firms, or other persons not employed by the auditor that are involved in the audit;
- Difficult or contentious matters for which the auditor consulted outside the engagement team;
- The auditor's evaluation of going concern;
- Expected departures from the auditor's standard report; and

- Other matters arising from the audit that are significant to the oversight of the company's financial reporting process, including complaints or concerns regarding accounting or auditing matters that have come to the auditor's attention during the audit.

Auditing Standard No. 16 retains from AU sec. 380 the option for auditors to communicate to audit committees either orally or in writing, unless otherwise specified in the standard. The auditor is required to document the communications in the work papers, regardless of whether the communications take place orally or in writing.

As part of the Proposed Rules, the Board adopted conforming amendments to several PCAOB standards, including PCAOB interim auditing standard AU sec. 722, "Interim Financial Information." In addition to the conforming amendments, the Board adopted transitional amendments to AU sec. 380 so that audit committee communications would continue to be required in audits of all SEC-registered broker-dealers in the event PCAOB standards become applicable to broker-dealer audits prior to the effective date of Auditing Standard No. 16.

The PCAOB has proposed application of its Proposed Rules to audits of all issuers, including audits of emerging growth companies ("EGCs"),<sup>9</sup> and the Proposed Rules also would apply to audits of SEC-registered brokers and dealers if the Commission subsequently determines to make PCAOB standards applicable to such audits.<sup>10</sup> The Proposed Rules would be effective for audits of financial statements with fiscal years beginning on or after December 15,

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<sup>9</sup> The term "emerging growth company" is defined in Section 3(a)(80) of the Exchange Act.

<sup>10</sup> The Commission proposed requiring application of PCAOB standards to audits for brokers and dealers in Release No. 34-64676 (June 15, 2011).

2012. The transitional amendments to AU sec. 380 would be effective for the periods that PCAOB standards become applicable to audits of SEC-registered brokers and dealers, as designated by the Commission, if the effective date of the application of PCAOB standards occurs prior to the effective date of Auditing Standard No. 16.

### **III. Comment Letters and the PCAOB's Responses**

As noted above, the Commission received five comment letters concerning the Proposed Rules. Two commenters expressed unqualified support for the Proposed Rules, and cited a link between Auditing Standard No. 16 and investor protection.<sup>11</sup> One of these commenters expressed its view that the matters Auditing Standard No. 16 requires auditors to communicate to audit committees are commensurate with, and supportive of, the important role audit committees have in serving the interests of investors through oversight of financial reporting and the audit process.<sup>12</sup> The other commenter cited its belief that adoption of Auditing Standard No. 16 is in the public interest and contributes to investor protection because it establishes requirements that enhance the relevance, timeliness, and quality of communications between auditors and audit committees.<sup>13</sup>

One of these commenters also expressed unqualified support for the application of the proposed rules to audits of EGCs and stated its belief that investors in public companies of all sizes are entitled to the same level of protection, including the protection provided by improved

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<sup>11</sup> See CAQ Letter and Deloitte Letter.

<sup>12</sup> See Deloitte Letter.

<sup>13</sup> See CAQ Letter.

communications between auditors and audit committees.<sup>14</sup> This commenter also cited the following points in support of its view:

- *Auditing Standard No. 16 will foster improved financial reporting.* The commenter believes improved financial reporting reduces information asymmetry and should increase the efficiency of capital allocation, thereby fostering capital formation. The commenter also believes this may be particularly important for EGCs, which may need to access the capital markets more regularly than more established companies.
- *Bifurcation of the requirements would be confusing as to the level of investor protection an investor is receiving.* The commenter believes that applying Auditing Standard No. 16 to audits of EGCs would avoid bifurcation of the rules applied to the preparation and audit of public company financial statements. The commenter also believes that having different sets of rules for different categories of public companies makes it more difficult for investors to know what rules governed the preparation and audit of a given set of financial statements.

Three commenters raised questions and concerns about the Proposed Rules and their proposed application. These matters relate to: (1) application of the Proposed Rules to audits of foreign private issuers (“FPIs”);<sup>15</sup> (2) application of Auditing Standard No. 16 to audits of

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<sup>14</sup> See CAQ Letter.

<sup>15</sup> The term “foreign private issuer” is defined in Exchange Act Rule 3b-4(c) [17 CFR 240.3b-4(c)]. A foreign private issuer means any foreign issuer other than a foreign government except an issuer that meets the following conditions: (1) more than 50 percent of the issuer’s outstanding voting securities are directly or indirectly held of record by residents of the United States; and (2) any of the following: (i) the majority of the executive officers or directors are United States citizens or residents; (ii) more than 50 percent of the assets of the issuer are located in the United States; or (iii) the business of the issuer is administered principally in the United States.

broker-dealers; (3) the role of management in communicating matters to the audit committee that are also the subject of Auditing Standard No. 16; (4) the specificity of the requirements in Auditing Standard No. 16; (5) potential regulatory conflicts; (6) convergence of auditing standards; and (7) the PCAOB's analysis supporting its proposal that the Proposed Rules apply to audits of EGCs (the "PCAOB's EGC analysis").

#### 1. Audits of FPIs

One commenter requested clarification as to whether or not the Proposed Rules would apply to audits of issuers that are FPIs.<sup>16</sup> The commenter stated that it was not seeking relief, solely clarity. In response to the commenter's request, the Commission notes that under the Sarbanes-Oxley Act, the PCAOB's auditing and other professional standards apply to audits of issuers.<sup>17</sup> There is no exception for issuers that are FPIs, and the PCAOB did not propose to create an exclusion. Accordingly, the Proposed Rules, consistent with other auditing standards adopted by the PCAOB, will apply to audits of FPIs.

#### 2. Audits of broker-dealers

One commenter requested more clarity about to whom the required Auditing Standard No. 16 audit committee communications should be made in situations when a broker-dealer does not have a board of directors or audit committee.<sup>18</sup> The commenter also recommended that the PCAOB make clear that the required communications should not be made to a chief financial officer or similar officer, but rather a chief executive officer. The commenter raised similar

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<sup>16</sup> See Quest Letter.

<sup>17</sup> See Sections 101(c)(2) and 103(a)(1) of the Sarbanes-Oxley Act.

<sup>18</sup> See Chamber Letter.

comments in connection with the PCAOB's own solicitation for comments on the Proposed Rules. The PCAOB revised Auditing Standard No. 16 in response to this comment, which was also raised by other commenters. The PCAOB revised the definition of audit committee with respect to non-issuers such that, if a non-issuer broker-dealer did not have a board of directors or audit committee, the required communications would be directed to the person(s) identified by the auditor as responsible for overseeing the accounting and financial reporting processes of the company.

However, the definition was not revised to exclude from the definition of audit committee those persons with oversight responsibility who also have management responsibilities for the preparation of the financial statements of the company. In its adopting release, the PCAOB stated that for non-issuers with no existing audit committee or board of directors (or equivalent body), the auditor would be expected to identify senior persons at the company who have decision-making authority and responsibility to oversee the accounting and financial reporting processes of the company and audits of the financial statements, and to make the required communications to those persons.<sup>19</sup> The PCAOB provided examples and stated that if all persons identified by the auditor as having responsibility for oversight of the company's accounting and financial reporting processes and audits also have management responsibilities for the preparation of the financial statements, then the auditor could also make the communications specified in the standard to other individuals at the company (e.g., the chief executive officer or others in charge of the company's operations and performance, who may

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<sup>19</sup> See PCAOB Release No. 2012-004 (August 15, 2012), pg. A4-3.

benefit from the communications). The Commission does not find the PCAOB's response to be unreasonable.

The commenter also requested that the PCAOB clarify to whom audit committee communications should be made when a broker-dealer is a subsidiary of an entity that has an audit committee.<sup>20</sup> The PCAOB addressed this comment in its adopting release as well. In that release, the PCAOB observed that some commenters suggested that the standard should clarify to whom the auditor should communicate when the company is a subsidiary of another entity. The PCAOB stated that Auditing Standard No. 16 does not require communication outside the governance structure of the audited entity because the standard designates the appropriate party to receive the auditor communications within the audited entity.<sup>21</sup> The PCAOB also stated that if directed by the audit client, or if the auditor otherwise deems it appropriate, the auditor could also communicate to a parent company audit committee or equivalent body. The Commission does not find the PCAOB's response to be unreasonable.

### 3. The role of management in communicating matters to the audit committee

One commenter repeated concerns expressed in letters to the PCAOB during the PCAOB's proposal stages that Auditing Standard No. 16 appears to shift inappropriately from management to auditors the primary responsibility to communicate to audit committees about matters of the selection and identification of significant and critical accounting policies, estimates and significant unusual transactions.<sup>22</sup> The commenter acknowledged that the PCAOB

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<sup>20</sup> See Chamber Letter.

<sup>21</sup> See PCAOB Release No. 202-004 (August 15, 2012), pg. A4-4.

<sup>22</sup> See Piercy Letter.

revised Auditing Standard No. 16 in response to this comment, and observed that Auditing Standard No. 16 is not intended to change the requirements of Rule 2-07 of Regulation S-X. However, the commenter believes the Commission should give consideration to its concerns and make “appropriate revisions” to Rule 2-07 to preserve what the commenter believes is the proper balance among the responsibilities of management, audit committees and auditors.

The Commission has previously considered views similar to those expressed by the commenter. Exchange Act Section 10A(k), as added by Section 204 of the Sarbanes-Oxley Act, directed the Commission to issue rules requiring timely reporting of specific information by auditors to audit committees. In response to this directive, in 2002, the Commission proposed amending Regulation S-X to require each public accounting firm registered with the Board that audits an issuer's financial statements to report, prior to the filing of such report with the Commission, to the issuer or registered investment company’s audit committee:<sup>23</sup>

(1) All critical accounting policies and practices used by the issuer or registered investment company;

(2) All alternative accounting treatments of financial information within generally accepted accounting principles that have been discussed with management, including the ramifications of the use of such alternative treatments and disclosures and the treatment preferred by the accounting firm; and

(3) Other material written communications between the accounting firm and management of the issuer or registered investment company.

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<sup>23</sup> See Release No. 33-8154 (December 2, 2002).

In response to this proposal, some commenters expressed a view that these communications should be the responsibility of management alone, while others expressed a view that both the accountant and management should share the responsibility for informing the audit committee about such matters. In adopting Rule 2-07, the Commission stated that “[w]hile we understand that management has the primary responsibility for the information contained in the financial statements, since the accounting firm is retained by the audit committee, we share the view reflected in Section 205 [sic] of the Sarbanes-Oxley Act and current auditing standards, that the accounting firm has a responsibility to communicate certain information to the audit committee.”<sup>24</sup> The Commission still holds this view and believes that the communications required by Auditing Standard No. 16 in this regard are appropriate.

Further, the Commission believes that additional changes made by the PCAOB in response to this concern are appropriate and balanced. In its adopting release, the PCAOB observed that in many companies, management might communicate matters involving management’s preparation of the company’s financial statements and that in many companies, management might communicate these matters or take the lead on communicating these matters to the audit committee. The PCAOB also observed that it does not have the authority to require management to communicate to the audit committee, and that certain communications are mandated by federal securities laws and Commission rules. Because of these factors, Auditing Standard No. 16 clearly recognizes and acknowledges that management might communicate to the audit committee certain matters related to the company’s financial statements; and in such

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<sup>24</sup> See Release No. 33-8183 (March 27, 2003).

circumstances, the auditor does not need to communicate those matters at the same level of detail as management, as long as certain conditions are met, as specified in the standard.

4. Level of specificity of requirements in Auditing Standard No. 16

One commenter observed that Auditing Standard No. 16 is “prescriptive” in that it contains specific mandatory communication requirements.<sup>25</sup>

The PCAOB addressed this comment in its letter to the Commission. In that letter, the PCAOB stated that its standards, including Auditing Standard No. 16, reflect the fact that a company’s size and complexity can affect the risks of material misstatement and that the Proposed Rules are designed to allow auditors to tailor the required communications to the size and level of complexity of a company’s operations, accounting practices, and audit issues.

The Commission addressed a similar comment in 2010 in connection with its consideration of rules proposed by the PCAOB to establish new risk assessment standards.<sup>26</sup> The Commission recognizes that there should be an appropriate balance in auditing standards between providing necessary minimum requirements and allowing auditors to apply judgment in determining the nature and extent of audit procedures given the particular circumstances of an individual engagement. The Commission believes that all PCAOB standards should reflect an appropriate balance of requirements and judgments that enables auditors to perform high quality and effective audits and believes the PCAOB’s approach in Auditing Standard No. 16 reflects a reasonable balance in this respect.

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<sup>25</sup> See Chamber Letter.

<sup>26</sup> See Release No. 34-63606 (December 23, 2010).

## 5. Potential regulatory conflicts

One commenter voiced concerns that the Proposed Rules may go outside of the scope of the PCAOB's jurisdiction over the audit and infringe upon the corporate governance responsibilities of the Commission or under applicable state law in overseeing the audit committee.<sup>27</sup> This commenter asked that the Commission review the Proposed Rules "with an eye towards eliminating any potential regulatory conflict." In considering the Proposed Rules, the Commission does not believe the Proposed Rules create any potential regulatory conflicts. In its adopting release, the PCAOB recognized the scope and limits of its jurisdiction. In one place, the PCAOB states that its definition of audit committee is not intended to conflict with or affect any requirements, or the application of any requirements, under federal law, state law, foreign law, or an entity's governing documents regarding the establishment, approval, or ratification of board of directors or audit committees, or the delegation of responsibilities of such a committee or board;<sup>28</sup> and in another place, the Board recognized that it does not have the authority to require management to communicate to the audit committee.<sup>29</sup>

## 6. Convergence of auditing standards

One commenter expressed support for the notion of working to achieve one set of global high quality auditing standards through the convergence of PCAOB auditing standards with those of the International Auditing and Assurance Standards Board ("IAASB") and the Auditing Standards Board of the American Institute of Certified Public Accountants ("ASB") and

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<sup>27</sup> See Chamber Letter.

<sup>28</sup> See PCAOB Release No. 202-004 (August 15, 2012), pg. A4-2.

<sup>29</sup> See PCAOB Release No. 202-004 (August 15, 2012), pg. 4.

observed that the Proposed Rules do not adequately identify and explain the rationale for differences between the Proposed Rules and the relevant standards of the IAASB and ASB.<sup>30</sup>

The PCAOB has received similar comments in the past, and has observed that:

[B]ecause the Board's standards must be consistent with the Board's statutory mandate, differences will continue to exist between the Board's standards and the standards of the IAASB and ASB, e.g., when the Board decides to retain an existing requirement in PCAOB standards that is not included in IAASB or ASB standards. Also, certain differences are often necessary for the Board's standards to be consistent with relevant provisions of the federal securities laws or other existing standards or rules of the Board.<sup>31</sup>

The Commission also addressed a similar comment in connection with its consideration of the rules proposed by the PCAOB to establish new risk assessment standards.<sup>32</sup> As noted then, the Commission encourages the Board's efforts to consider standards issued by the IAASB and the ASB, and appreciates the reasons why it is reasonable to expect that the Board's standards may appropriately differ from such standards. In this regard, we take note of the efforts the PCAOB has taken in developing the Proposed Rules to consider the work of other standard setters.

#### 7. The PCAOB's EGC request and the Commission's EGC determination

Section 103(a)(3)(C) of the Sarbanes-Oxley Act provides that any additional rules adopted by the PCAOB subsequent to April 5, 2012 do not apply to the audits of EGCs, unless the Commission determines that the application of such additional requirements is necessary or appropriate in the public interest, after considering the protection of investors and whether the

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<sup>30</sup> See Chamber Letter.

<sup>31</sup> See PCAOB Release No. 2010-004, August 5, 2010, pp. A10-91 - A10-92 (internal footnotes omitted).

<sup>32</sup> See supra note 26.

action will promote efficiency, competition, and capital formation.<sup>33</sup> Having considered those factors, and as explained further below, the Commission finds that applying the Proposed Rules to audits of EGCs is necessary or appropriate in the public interest.

The PCAOB adopted Auditing Standard No. 16 on August 15, 2012 for application to audits of all issuers, including EGCs; and the PCAOB requested that the Commission make the determination required by Section 103(a)(3)(C) such that Auditing Standard No. 16 would apply to audits of EGCs. To assist the Commission in making its determination, the PCAOB prepared and submitted to the Commission its own EGC analysis. The PCAOB's EGC analysis includes discussions of: (1) the background of and reasons for the new standard; (2) the PCAOB's approach to developing the new standard, including consideration of alternatives; (3) key changes and improvements from existing audit committee communication requirements; and (4) characteristics of EGCs and economic considerations.

In developing its analysis, the PCAOB compiled data available from entities voluntarily identifying themselves as EGCs in SEC filings. Based on data available to the PCAOB, the Board observed that one key difference between EGCs and other entities appears to be the length of time an EGC has been subject to the reporting requirements under the Exchange Act.<sup>34</sup> The Board also observed that the enhanced audit committee communication requirements of Auditing Standard No. 16 may be of particular benefit to EGCs given that: (1) some EGCs are companies that are relatively new to the SEC reporting process, and may have new audit committee

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<sup>33</sup> Section 103(a)(3)(C) of the Sarbanes-Oxley Act, as amended by Section 104 of the Jumpstart Our Business Startups Act (the "JOBS Act").

<sup>34</sup> See 77 Fed. Reg. at 57448.

members that may be less familiar with SEC reporting requirements and have relatively more questions regarding how to present their financial statements for SEC reporting purposes; and (2) some EGCs may also be considering, for the first time, initial choices in their accounting policies and practices that could have implications for their financial reporting.<sup>35</sup>

The PCAOB's EGC analysis was included in the Commission's public notice soliciting comment on the Proposed Rules. Based on the analysis submitted, the comments received, and the PCAOB's response, we believe the information in the record is sufficient for us to make the EGC determination in relation to this standard. Specifically, the PCAOB's EGC analysis discussed its approach to developing the new standard and its consideration of alternatives, as well as the characteristics of EGCs and economic considerations. The Commission also takes note, in particular, of the PCAOB's overall approach to Auditing Standard No. 16, which was designed to: (1) scale the required communications to the size and complexity of the company being audited; (2) maintain flexibility (e.g., with respect to auditors communicating orally or in writing); (3) minimize duplicative or redundant communications to the audit committee from the auditor and management; (4) focus the communications on the accounting matters that are significant to the auditor and the audit committee; and (5) reduce auditors' search costs (i.e., the costs associated with researching the federal securities laws' and auditing standards' various communication requirements) by providing a list of other PCAOB standards and rules that contain audit committee communication requirements in one place. Moreover, the auditor's requirements under the new standard are focused on communicating the results of audit procedures that the auditor is already required to perform.

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<sup>35</sup> See 77 Fed. Reg. at 57447.

One commenter raised concerns about the PCAOB's EGC analysis.<sup>36</sup> This commenter did not assert that any specific aspect of Auditing Standard No. 16 should not apply to audits of EGCs. Rather, the commenter raised several concerns about the substance and form of the PCAOB's EGC analysis and whether it was sufficient to form a basis for the Commission's EGC determination. We discuss each of this commenter's main points, and set forth our responses, separately below.

- First, the commenter states that because the JOBS Act provides an automatic exemption for EGC audits from any future PCAOB rules, there is a special burden on the Commission to determine that benefits outweigh costs in order to reverse a clear Congressional directive in favor of an exemption.

As noted above, Section 103(a)(3)(C) of the Sarbanes-Oxley Act contains very specific provisions concerning the application of PCAOB rules to audits of EGCs. The statutory text of Section 103(a)(3)(C) demonstrates that where Congress intended to provide EGCs with an absolute exemption from future PCAOB rules, it did so explicitly (e.g., that any future PCAOB rules on mandatory audit firm rotation or an auditor discussion and analysis shall not apply to EGCs audits). By contrast, with respect to other future PCAOB rules, Congress indicated that new requirements may apply to EGCs, but that for them to apply, the Commission needs to make a determination that such application is "necessary or appropriate in the public interest, after considering the protection of investors, and whether the action will promote efficiency, competition, and capital formation." This determination is separate from the existing finding needed to approve a PCAOB proposed rule change under Section 107 of the Sarbanes-Oxley Act

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<sup>36</sup> See Chamber Letter.

that the proposed rule is consistent with the requirements of the Sarbanes-Oxley Act and the securities laws, or is necessary or appropriate in the public interest or for the protection of investors.<sup>37</sup>

Just as the Section 107 finding does not require the Commission to overcome a “presumption” that a proposed PCAOB rule should be disapproved, the Section 103 EGC determination does not require the Commission to overcome a “presumption” that a PCAOB proposed rule should not apply to audits of EGCs. Rather, in both instances, the statute sets forth a predicate finding that the Commission must make, after considering specified factors, in order for the rule to be approved (section 107(b)(2)) or for it to apply to EGC audits (Section 103(a)(3)(C)).

The statutory text of Section 103(a)(3)(C) requires the Commission to *consider* the protection of investors and whether the action will promote efficiency, competition, and capital formation as part of its affirmative *determination* that the application of such additional requirements is necessary or appropriate in the public interest. Plainly this involves considering the economic effects of the Proposed Rules as they relate to efficiency, competition and capital formation.

- Second, the commenter believes the PCAOB’s EGC analysis is “devoid of any semblance of an analysis of the cost of compliance with the rule for all issuers or for EGCs,” and asserts that the PCAOB, in its EGC analysis, cited a belief that Auditing Standard No. 16 would be less costly for EGCs.

The PCAOB did provide information regarding potential costs of the proposed rules to issuers, including EGCs. The PCAOB’s analysis included qualitative factors that would affect

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<sup>37</sup> See Section 107(b)(3) of the Sarbanes-Oxley Act. As discussed below, the Commission makes both findings. The Commission makes each finding on its own merits and does not consider either one dependent on the other.

such costs (e.g., nature or complexity of the issuer). As noted above, the PCAOB also provided an analysis of the characteristics of EGCs, including data on the number of issuers that have voluntarily disclosed their EGC status after enactment of the JOBS Act. In its analysis, the PCAOB noted that EGCs vary widely in size, and noted that one key difference between EGCs and other entities appears to be the length of time an EGC has been subject to the reporting requirements under the Exchange Act. In this regard, the PCAOB further described how this difference may in fact relate to the ability of the Proposed Rules to promote efficiency and capital formation for EGCs over other issuers.

Notwithstanding the commenter's assertion that the PCAOB believes the application of Auditing Standard No. 16 would be less costly for EGCs, no such statement is expressed in the PCAOB's EGC analysis. Rather, the PCAOB's EGC analysis reflects the Board's view that a company's size and complexity can affect the risks of material misstatement, and therefore, auditing challenges and audit strategies (matters that impact the amount of time and effort put into an audit). This point was reiterated in the PCAOB's letter to the Commission. In that letter, the PCAOB also provided examples of how communications required by Auditing Standard No. 16 could be tailored to the audit of a less complex company, which could have an impact on the overall cost of the audit and could help to avoid unnecessary costs.

Section 103(a)(3)(C) does not require the Commission to conclude that a proposed PCAOB rule would be "less costly" for EGC audits than for other issuer audits in order to find that applying the rule to EGC audits would be necessary or appropriate in the public interest. The relative impact on EGCs *vis a vis* other issuers could be a factor to consider in whether the application of the proposed rules to EGC audits is necessary or appropriate in the public interest,

after considering the protection of investors and whether the action will promote efficiency, competition, and capital formation. However, nothing in the statutory text indicates that the Commission's public interest finding hinges on whether, on a categorical basis, the requirements of a given PCAOB rule would be less costly for EGCs.

- Third, the commenter disputes the relevance of existing audit committee communication requirements under PCAOB interim auditing standard AU sec. 380 to a discussion of the application of Auditing Standard No. 16 to audits of EGCs.

The Commission does not view the PCAOB's discussion of the Proposed Rules in relation to the existing standards as inconsistent with the proper analysis of an EGC determination. Rather, establishing a baseline for conducting an analysis of economic effects of a proposed regulatory action is an appropriate regulatory practice. Also, it is important to consider that currently, all issuers, including EGCs, are subject to the existing audit committee communication requirements of AU secs. 310 and 380 and Rule 2-07 of Regulation S-X. If the Commission determined that the Proposed Rules should not apply to audits of EGCs, AU secs. 310 and 380 and Rule 2-07 of Regulation S-X would still apply to the audits of EGCs.<sup>38</sup>

The Commission believes the PCAOB's EGC analysis appropriately describes the consequences of the Proposed Rules relative to the baseline. As the PCAOB notes in its submission, the impact of the Proposed Rules is largely incremental to existing requirements regarding communications between auditors and audit committees. Accordingly, this discussion

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<sup>38</sup> Also, the Commission does not view the PCAOB's highlighting the existing baseline as the sole justification to carry forward existing requirements. Rather, throughout the PCAOB's submission describing the individual requirements of the standard, while the PCAOB notes whether the particular requirement is new or carried forward, the PCAOB also explains why it chose to include them irrespective of whether they already are included in the existing standards.

of existing requirements is highly relevant to considering the impacts on efficiency, competition and capital formation that would be caused by applying the new standard to audits of EGCs. The Commission does not believe the Proposed Rules can be categorized as a major or profound change to the way auditors communicate with audit committees. In fact, the PCAOB received comments to this effect during its own due process. For example, one commenter observed that “many of the requirements [of the proposed rules] are already reflected in the best practices of audit firms and public companies.”<sup>39</sup> Another commenter to the PCAOB stated its “belie[f] that auditors, in most cases, are already providing meaningful communications on the financial statement and audit areas that meet the spirit of the requirements of the Proposed Standard and go beyond what is currently required by the extant standards.”<sup>40</sup>

- Fourth, the commenter raised a concern that the public was never afforded an opportunity to comment upon the impact of the proposed rules on the audits of EGCs.

Section 103(a)(3)(C) requires the Commission to make the specified determination. The PCAOB submitted an EGC analysis that assisted the Commission in its own determination. The PCAOB’s analysis was included in the Commission’s notice of the Proposed Rules which provided an opportunity for the public, including the commenter, to submit comments on the analysis.<sup>41</sup> The PCAOB also supplemented the record with additional information after

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<sup>39</sup> See letter from The Society of Corporate Secretaries and Governance Professionals to the PCAOB (June 1, 2010). This letter may be viewed at: [http://pcaobus.org/Rules/Rulemaking/Docket030/032\\_SCSGP.pdf](http://pcaobus.org/Rules/Rulemaking/Docket030/032_SCSGP.pdf).

<sup>40</sup> See letter from Deloitte & Touche to the PCAOB (May 28, 2010). This letter may be viewed at: [http://pcaobus.org/Rules/Rulemaking/Docket030/020\\_DT.pdf](http://pcaobus.org/Rules/Rulemaking/Docket030/020_DT.pdf).

<sup>41</sup> In addition, the commenter acknowledged that the JOBS Act was signed into law after the PCAOB’s second comment period closed. The PCAOB did not re-expose the Proposed Rules again as part of its standard-setting process to seek public input on whether application of the Proposed Rules to EGC audits would be necessary or

comments were received. As noted above, based on the analysis submitted, the comments received, and the PCAOB's response, we believe the information in the record is sufficient for us to make the EGC determination.

- Fifth, the commenter believes that the inspection findings cited in the PCAOB's EGC analysis do not provide any indication whether any of the audit committee communication failures involved the audits of EGCs. The commenter also criticizes the relevance of the PCAOB's citation to four year old research that indicated that audit committee oversight was having a positive impact on the overall quality of audits.

In its EGC analysis, the PCAOB cited its inspection findings as one input into its decision to bring together in one place audit committee communication requirements;<sup>42</sup> and in its letter to the Commission, the PCAOB reiterated this point. The Commission believes it was appropriate for the PCAOB to consider its inspection findings in developing the Proposed Rules.

As to the PCAOB's reference in its EGC analysis to research, the Commission believes it was wholly appropriate for the PCAOB to highlight the relationship between audit committee communications and overall audit quality and improved financial reporting, given the relevance of the quality of financial reporting to considerations of efficiency and capital formation. It does not appear that the PCAOB was referencing the research identified by the commenter to justify the Proposed Rules themselves or was attempting to use research inconsistently or opportunistically to support its views. Rather, the PCAOB noted, citing to other research, that improved financial reporting quality promotes efficiency and capital formation. The PCAOB explained that the results of one of the studies cited in its EGC analysis supported its view that

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appropriate in the public interest, after considering the protection of investors, and whether the action will promote efficiency, competition, and capital formation.

<sup>42</sup> See 77 Fed. Reg. at 57441.

audit committee oversight of the auditor improves audit quality and financial reporting quality. The PCAOB then went on to discuss additional findings from its outreach and research that improved interaction between, and information shared, between the auditor and the audit committee enhances audit committee oversight and auditor performance.

#### **IV. Conclusion**

The Commission has carefully reviewed and considered the Proposed Rules and the information submitted therewith by the PCAOB, including the PCAOB's EGC analysis, the comment letters received, and the PCAOB's response. In connection with the PCAOB's filing and the Commission's review,

A. The Commission finds that the Proposed Rules are consistent with the requirements of the Sarbanes-Oxley Act and the securities laws and are necessary or appropriate in the public interest or for the protection of investors; and

B. Separately, the Commission finds that the application of the Proposed Rules to EGC audits is necessary or appropriate in the public interest, after considering the protection of investors and whether the action will promote efficiency, competition, and capital formation.

IT IS THEREFORE ORDERED, pursuant to Section 107 of the Act and Section 19(b)(2) of the Exchange Act, that the Proposed Rules (File No. PCAOB-2012-01) be and hereby are approved.

By the Commission.

Elizabeth M. Murphy  
Secretary

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